Fund Evaluation Group®
investment advisors

RESEARCH REVIEW

AUGUST 2017

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Second quarter U.S. economic growth was upwardly revised in August, reflecting the strongest quarterly growth rate in more than two years. Across the major asset categories, global equities experienced modestly positive returns, with performance generally stronger in international markets, while fixed income markets experienced a modest flight-to-quality rally, benefiting higher quality sectors. Despite a potentially more favorable U.S. growth backdrop, energy-infrastructure assets experienced significant downside.

Economic Update

U.S. Second Quarter Growth Improves to Two-Year High

The second estimate of second quarter U.S. GDP growth, released by the Bureau of Economic Analysis on August 30, shows that economic growth has accelerated at a stronger rate than was first estimated, with real GDP accelerating to 3.0%, 40 basis points (bps) higher than the "advance" estimate of 2.6%. The 3.0% quarterly growth rate was the strongest since first quarter 2015 and helped propel the year-over-year (YoY) rate from 2.1% to 2.2%. While the 2.2% YoY rate was essentially in-line with 12-month measures witnessed in the current economic expansion, the 3.0% quarterly growth rate garnered significant attention. Encouragingly, the Atlanta Fed's GDPNow™ current quarter GDP model estimates third quarter growth at a solid 2.9% as of September 6, 2017, although the model estimate has grinded lower in recent weeks.

The level of "slack" in the economy that has existed since the 2008-2009 Global Financial Crisis appears to have been almost completely been worked off through the second quarter, as the output gap narrowed to -0.3%, reflecting realized growth that is essentially in-line with potential growth.

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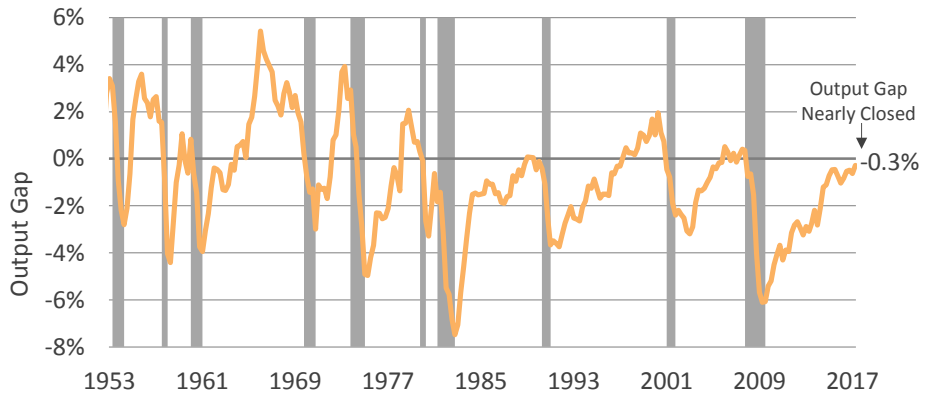
U.S. OUTPUT GAP AND BUSINESS CYCLES



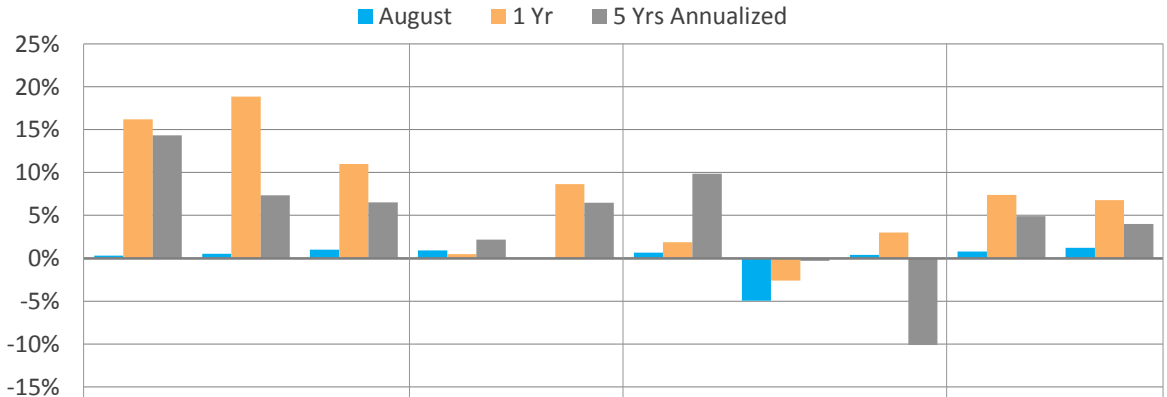
Data sources: CBO, NBER, Bloomberg, L.P.; Data as of 2Q 2017
Note: Positive readings indicate over-utilization and vice versa

The combination of a somewhat mature economic expansion, a nearly closed output gap, elevated valuations across most risky asset categories, and the prospect for late-cycle fiscal stimulus has the potential to lead to elevated inflation rates over the medium-term horizon. Since February, however, inflation has cooled materially and expectations for near-term stimulus measures have taken a backseat, as the U.S. grapples with rising geopolitical tensions surrounding North Korea, natural disasters, and debt ceiling negotiations.

In summary, U.S. economic growth was revised upward to 3.0% in the second quarter, reflecting the strongest quarterly growth rate in more than two years. Meanwhile, the level of "slack" in the economy has diminished significantly since the Global Financial Crisis—with the output gap closing in on 0%—and any introduction of fiscal stimulus has the potential to drive sagging inflation rates higher over the medium-term horizon.

Market Summary

AUGUST 2017



	GLOBAL EQUITY			GLOBAL FIXED INCOME		REAL ASSETS			DIVERSIFYING STRATEGIES	
	S&P 500 Index	MSCI ACWI ex-U.S.	HFRI Equity Hedge Index	Blmbrg Barclays U.S. Agg Index	Blmbrg Barclays HY Index	FTSE NAREIT All Equity Index	Alerian MLP Index	Blmbrg Cmdty Index	HFRI Fund Wtd Comp. Index	HFRI Fund of Fund Index
August	0.3%	0.5%	1.0%	0.9%	0.0%	0.6%	-4.9%	0.4%	0.8%	1.2%
1 Yr	16.2%	18.9%	11.0%	0.5%	8.6%	1.9%	-2.6%	3.0%	7.4%	6.8%
5 Yrs Annualized	14.3%	7.4%	6.5%	2.2%	6.5%	9.9%	-0.3%	-10.1%	4.9%	4.0%

Data sources: Lipper, HedgeFund Research

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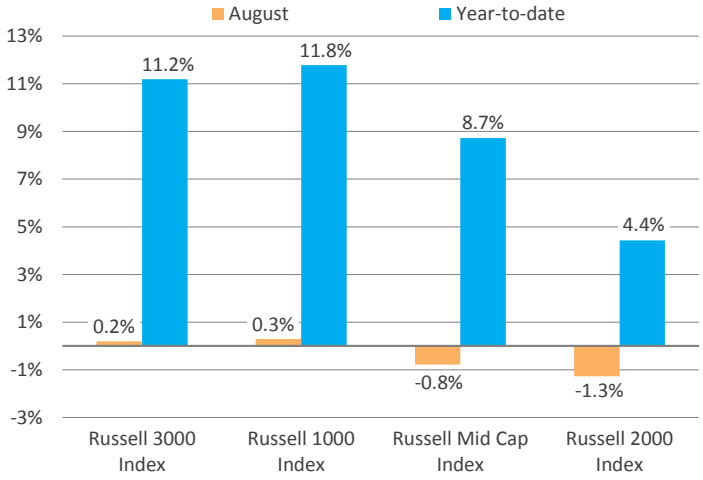
Global Equity

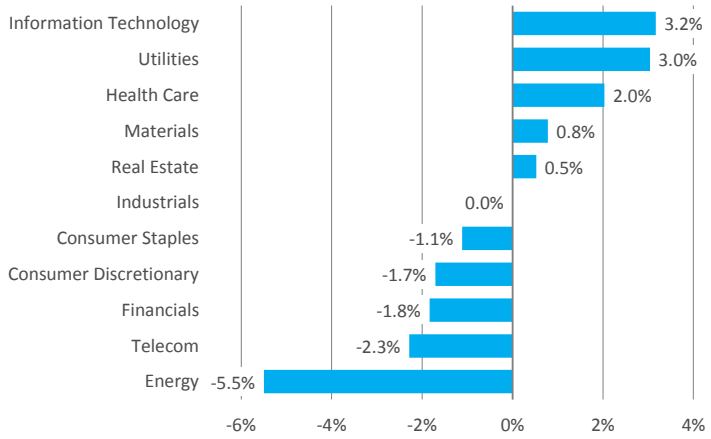
- Equity returns were modest in the U.S. despite strength in earnings; nevertheless, August marked the eighth consecutive month of positive returns for the S&P 500. Small cap stocks continued to underperform in 2017, retreating from lofty valuations coming into the year.
- Growth continued to outperform against value, as technology stocks led the U.S. equity market.
- Weakness in the energy and financials sectors exacerbated the divergence in performance, as these two sectors comprise more than 35% of the Russell 3000 Value Index and less than 5% of the Russell 3000 Growth Index, respectively.
- International developed markets were essentially flat in August despite continued positive momentum in economic growth. The euro zone reported the highest GDP growth since 2011, while Japan reported an unexpected 4% GDP growth for the second quarter.
- The euro zone experienced a welcome rise in inflation to 1.5% and consumer confidence neared a 10-year high; however, persistently low inflation in Japan remained a key concern.
- Emerging markets posted more strong returns, with the region significantly outpacing developed markets for the year. China—which comprises a significant weight in emerging markets indices—was the key driver of strength in the emerging markets, as second quarter GDP growth was just shy of 7%. A weaker dollar continued to provide additional support.

RUSSELL INDICES PERFORMANCE



Data source: Russell

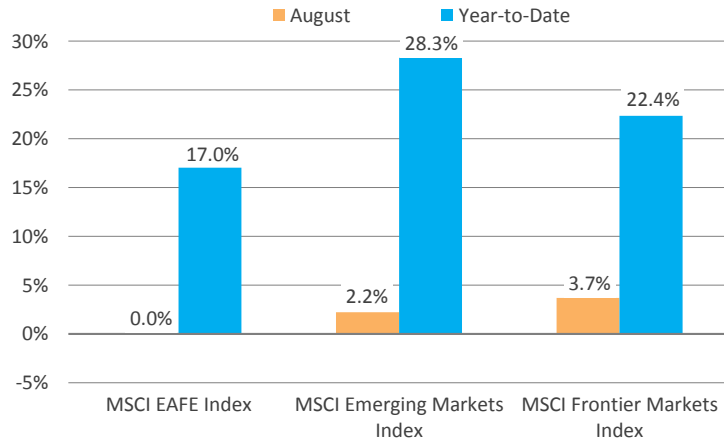
AUGUST RUSSELL 3000 SECTOR PERFORMANCE



Data source: Russell

MSCI INDICES PERFORMANCE

Returns in U.S. Dollars



Data source: MSCI

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Fixed Income

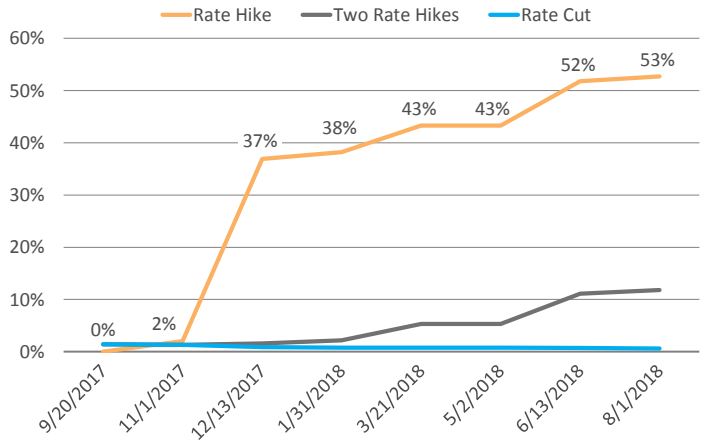
MARKET DRIVERS

- Corporate earnings have continued to exceed expectations and could enjoy a small tailwind due to the weaker dollar; earnings strength has kept corporate default expectations benign.
- The Fed plans to shrink their balance sheet relatively soon and expectations for a rate hike in December have muted considerably. The market is currently implying a 37% probability of a third rate hike by year-end, down from 57% at the end of June.

MARKET MOVEMENT

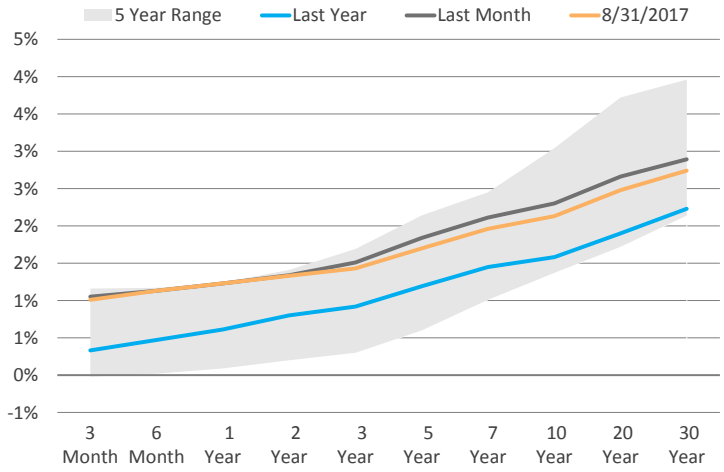
- Risk-on sentiment continued to rally, with no major changes to the stability of corporate credit fundamentals.
- Developed and emerging market debt has continued to perform well, benefitting from the broad decline in the U.S. dollar.
- The yield curve flattened slightly for the month due to declining rates at the long end of the curve. This was seen by some as a minor flight to quality stemming in part from geopolitical concerns around North Korea.

IMPLIED PROBABILITY OF FED DECISION



Data source: CME Group

TREASURY YIELD CURVE



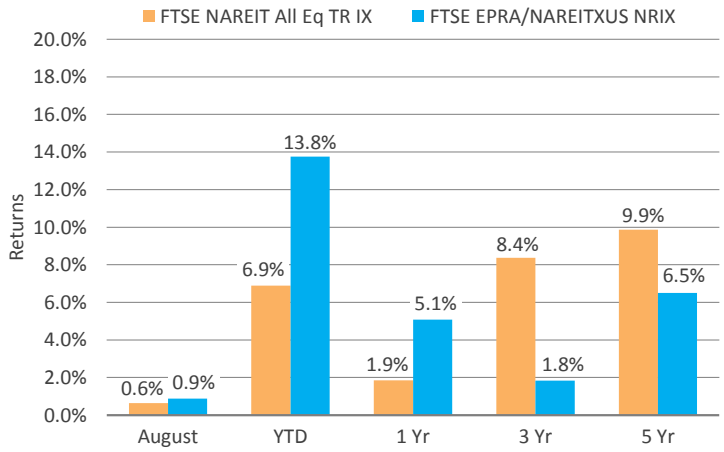
Data source: St. Louis Federal Reserve

Real Assets

REAL ESTATE

- Domestic and international real estate securities were relatively flat in August, which can be attributed to investor reluctance around broader macroeconomic activity.
- Domestic REITs had positive growth in the industrial real estate sector (+3.6%), which benefitted from strengthening fundamentals following the second quarter's improved GDP estimate.
- International real estate securities were positively affected by continued capital inflows in the office and mall sectors throughout Europe and Asia.

DOMESTIC vs. INTERNATIONAL REIT RETURNS



Data source: Lipper

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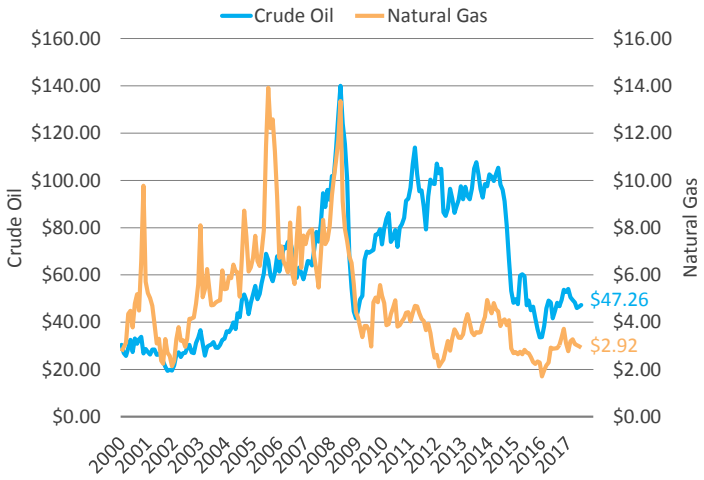
NATURAL RESOURCES

- Oil prices gained 1.4% in August and closed at $47.26/barrel. Hurricane Harvey helped support energy prices, as demand began to exceed supply. Additionally, a weaker dollar and backwardated futures curves assisted oil gains.
- Master limited partnerships retreated materially in August, in part as a response to the potential damage Hurricane Harvey might have had on energy infrastructure in the affected areas.
- The broader commodity market, as measured by the Bloomberg Commodity Index, rose a modest 0.4%, supported by the 9.6% gain in the industrial metal sector. Industrial metal prices, such as copper and aluminum, were buoyed by demand exceeding supply by the highest levels in a decade.

CRUDE OIL AND NATURAL GAS PRICES



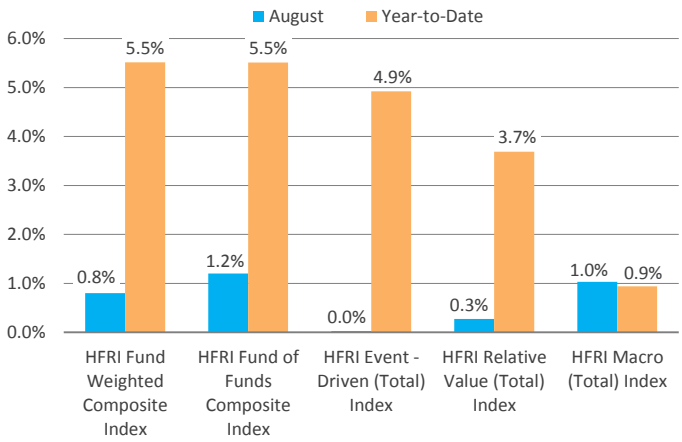
Data source: Energy Information Agency

Diversifying Strategies

- Volatility levels rose from historic lows but remained below long-term averages, largely due to geopolitical tensions and contentious debates in Washington D.C., including the impending debt ceiling deadline.
- Rising volatility particularly benefitted quantitative strategies such as statistical arbitrage and managed futures. Distressed and credit strategies tended to lag throughout the month due to rising levels of macro uncertainty.
- Discretionary global macro managers had their sights set on the Jackson Hole Symposium, which seemingly failed to deliver any substantial forward guidance on interest rate hikes or balance sheet reductions. As a result of what many believed to be dovish commentary from Federal Reserve Chair Janet Yellen, falling interest rates and the depreciation of the U.S. dollar generated mixed—but slightly negative—performance for discretionary managers.

HFRI INDICES PERFORMANCE

Returns in U.S. Dollars



Data source: HedgeFund Research

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Investments in private funds are speculative, involve a high degree of risk, and are designed for sophisticated investors.

All data is as of August 31, 2017 unless otherwise noted.

INDICES

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class.

Barclays Capital Fixed Income Indices is an index family comprised of the Barclays Capital Aggregate Index, Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, Municipal Index, High-Yield Index, and others designed to represent the broad fixed income markets and sectors within constraints of maturity and minimum outstanding par value. See https://ecommerce.barcap.com/indices/index.dxml for more information.

The CBOE Volatility Index (VIX) is an up-to-the-minute market estimate of expected volatility that is calculated by using real-time S&P 500 Index option bid/ask quotes. The Index uses nearby and second nearby options with at least 8 days left to expiration and then weights them to yield a constant, 30-day measure of the expected volatility of the S&P 500 Index. FTSE Real Estate Indices (NAREIT Index and EPRA/NAREIT Index) includes only those companies that meet minimum size, liquidity and free float criteria as set forth by FTSE and is meant as a broad representation of publicly traded real estate securities. Relevant real estate activities are defined as the ownership, disposure, and development of income-producing real estate. See www.ftse.com/Indices for more information.

HFRI Monthly Indices (HFRI) are equally weighted performance indexes, compiled by Hedge Fund Research Inc. (HFX), and are used by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 37 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database. The HFRI Fund of Funds Composite Index is an equal weighted, net of fee, index composed of approximately 800 fund- of- funds which report to HFR. See www.hedgefundresearch.com for more information on index construction.

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Merrill Lynch high yield indices measure the performance of securities that pay interest in cash and have a credit rating of below investment grade. Merrill Lynch uses a composite of Fitch Ratings, Moody's and Standard and Poor's credit ratings in selecting bonds for these indices. These ratings measure the risk that the bond issuer will fail to pay interest or to repay principal in full. See www.ml.com for more information.

Morgan Stanley Capital International – MSCI is a series of indices constructed by Morgan Stanley to help institutional investors benchmark their returns. There are a wide range of indices created by Morgan Stanley covering a multitude of developed and emerging economies and economic sectors. See www.morganstanley.com for more information.

Russell Investments rank U.S. common stocks from largest to smallest market capitalization at each annual reconstitution period (May 31). The primary Russell Indices are defined as follows: 1) the top 3,000 stocks become the Russell 3000 Index, 2) the largest 1,000 stocks become the Russell 1000 Index, 3) the smallest 800 stocks in the Russell 1000 Index become the Russell Midcap index, 4) the next 2,000 stocks become the Russell 2000 Index, 5) the smallest 1,000 in the Russell 2000 Index plus the next smallest 1,000 comprise the Russell Microcap Index. See www.russell.com for more information.

S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation, among other factors by the S&P Index Committee, which is a team of analysts and economists at Standard and Poor's. The S&P 500 is a market-value weighted index, which means each stock's weight in the index is proportionate to its market value and is designed to be a leading indicator of U.S. equities, and meant to reflect the risk/return characteristics of the large cap universe. See www.standardandpoors.com for more information.

Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com.

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